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Financial Markets

Irving Trust

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Economic Research &
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Friday
(Noon)

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The debate continues: Did it or didn't it? Right now, only the FOMC knows for sure. The debate, of course, is over the question of whether the Fed has tightened its policy. Instead of speculating about likely prospects, let's see what kind of policy actions the Fed has been dealing out; let's peek into its hand.

When it comes to Fed action (rather than reaction, where money supply is the key), the market looks most closely at the rate for Fed funds and at the net (free or borrowed) reserve position of banks vis-a-vis the Fed. The average, or effective, Fed funds rate has risen week by week since May 11, the week of the infamous $7.2 billion M1 increase. The effective Fed funds rate rose from a low of 8.48% that week to 9.14% for the week ending June 22 (These are weeks in the sense of reserve maintenance periods: Thursday to Wednesday). Over that same period, the net reserve position of banks with the Fed swung back and forth: three weeks of net free reserves, four weeks of net borrowed--no clear pattern. Some analysts claim that this is evidence that the Fed is not behind the increase in the funds rate. They assert that the Fed is leaving free reserves in the system on occasion rather than restricting the supply of reserves to force borrowing from the Fed, an action that could pressure interest rates. This is the argument, but I think it is wrong. It peeks at only a few of the cards in the Fed's hand.

Remember that the Fed deals out reserves all week long, and so the funds rate is the result of the actual (and expected) supply of reserves in the market throughout the week, not just at the week's end. Realizing this, we can reveal the Fed's hand. In the six weeks following the $7.2 billion surprise, five saw net free reserve positions on Wednesday--the last day of the statement week. Each of the previous six weeks had shown net borrowed reserves on Wednesday, a sharp change in practice. This change implies a marked impact on the rest of the week's reserve pattern: Thursday to Tuesday. It means that after May 11, the Fed switched from its past policy of holding free reserves in the market all week and tightening on Wednesday, to the opposite policy of keeping reserves tight all week long, then injecting more on Wednesday. For example, during the first six days of each of the six weeks after May 11, five were periods of net borrowed reserves. The previous five weeks had shown just the opposite behavior for comparable six-day periods. Interest rates have firmed since May 11 because Fed funds traders usually have found their market short of reserves (all days of the week, save one), and this has been Fed policy.

The Fed has used a period of market uncertainty amid concern over money supply growth to impart firmness to the Fed funds rate. It has done this in a way that is very subtle and has analysts arguing over Fed intentions even after the rate has risen 50 to 60 basis points! However, a closer peek over the Fed's shoulder and into its hand does reveal the Fed's strategy. This clearly has been to raise rates without creating too much commotion in a period of great uncertainty over the economy. We can expect the Fed to continue to play these obscure hands.

Robert A. Brusca

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Market Yields

	7/1/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	10.50%	10.50%	16.50%
Effective since	2/28/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	12.00
Federal Funds	9.38	9.00	14.88
Repurchase Agreements	9.38	8.88	12.00
U.S. Treasury Issues			
Bills			
3 months	9.07	9.32	13.10
6 months	9.43	9.61	14.00
1 year	9.63	9.86	14.28
Coupons			
2 years	10.23	10.41	14.62
4 years	10.63	10.73	14.74
7 years	10.92	10.96	14.67
10 years	10.94	10.96	14.43
Long Bond	11.00	11.01	13.91
Negotiable Certificates of Deposit-Secondary Market			
1 month	9.10	9.30	14.85
3 months	9.20	9.30	15.15
6 months	9.45	9.60	15.35
1 year	9.85	9.95	15.35
Banker's Acceptances			
1 month	9.05	9.24	14.85
3 months	9.15	9.42	15.15
6 months	9.45	9.64	15.30
Eurodollar Deposits			
1 month	9.50	9.63	15.50
2 months	9.63	9.75	15.75
3 months	9.63	9.75	15.88
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.02	8.63	14.74
1 month	9.19	9.33	15.02
3 months	9.34	9.34	15.25
Bank Holding Companies			
1 month	9.07	9.07	14.88
Dealer Placed:			
3 months	9.43	9.56	15.25
New AA Corporate Utility Bond	12.15	12.10	16.50
Tax Exempt			
6 month Project Notes	4.75	4.80	7.95
1 year AAA Bond	5.50	5.10	8.25
5 year AAA Bond	7.00	6.50	9.60
20 year AAA Bond	9.40	9.40	11.75

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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